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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Docket No. EP 705

COMPETITION IN THE RAILROAD INDUSTRY

SUPPLEMENTAL COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

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Pursuant to the Board's Order dated June 30, 2011, which left the record in this proceeding open until July 25, 2011, "to allow parties to supplement their testimony to respond to questions raised at the hearing," the Association of American Railroads ("AAR") respectfully submits these Supplemental Comments. AAR previously filed Initial Comments on April 12, 2011, and Reply Comments on May 27, 2011. Five AAR witnesses presented testimony and responded to questions from the Board at the oral hearing in this matter held on June 22, 2011.

I. INTRODUCTION

A. What Is the Problem that Shippers Are Asking the Board to Address in this Proceeding?

The Board asked in a number of different ways and contexts at the June 22-23 hearing, "What is the problem that the Board should address in this proceeding?" As a preliminary matter, it is important not to lose sight of the fact that during the course of this proceeding over a hundred railroad customers expressed, in one form or another, the view that the Board should take no action that would impede the railroads' ability to continue to invest in the future. The responses of complaining shippers to the Board's question confirmed that the overwhelming interest of those seeking to change the Board's competitive access rules was to obtain lower rates. That is, shippers are pursuing increased access as a means to get lower rail rates than would be warranted under an economically sound scheme of rate regulation. As a result, they essentially ignore the central policy issues related to involuntary access, including alternative conduct-based standards that might justify access, how to determine the appropriate prices at which access might be granted, and the impact of shippers' proposals on railroad investment, capacity, productivity, and service. Many proponents of changed access rules acknowledged at the hearing that rail service is not the problem; instead, the focus was on access as a vehicle for obtaining lower rates.

The shippers appear preoccupied with the fact that, after years of steady decline, rail rates rose in the first decade of this century. While this fact is indisputable, the shippers' assertion that these rate increases are attributable to a reduction in rail-to-rail competition is essentially a made-for-litigation story constructed from the incessant repetition of unsubstantiated assertions.[1] The real sources of rail rate increases have been identified by the experts whom the Board recently hired to address the issue of competition in the rail industry. "The increase in railroad rates experienced in recent years is the result of declining productivity growth and increased costs

[1] Another made-for-litigation story propounded by some shippers in this proceeding is that high rail rates are driving chemical companies offshore. As demonstrated by a recent opinion piece in *Roll Call* by Calvin M. Dooley, president and CEO of the American Chemistry Council, the price of natural gas, not rail rates, is the determining factor in chemical industry decisions about whether to invest in U.S. facilities or in overseas facilities. In that article, Mr. Dooley also decries proposed legislation that would "constrain supply or distort markets" for natural gas that are "already developing . . . where the fundamentals support it" and increase volatility in natural gas prices. Mr. Dooley argues that stable natural gas prices have led to a resurgence of the American chemical industry and have provided the industry with a comparative advantage over foreign producers. According to Mr. Dooley, government intervention that would distort markets threatens that progress: "But as anyone who owns a business knows, investment decisions are based on certainty and a positive view of the future. By injecting volatility into natural gas markets, policies such as the NAT GAS Act undermine the certainty chemical companies need to justify new investments and create jobs." Calvin M. Dooley, "Dooley: NAT Gas Act Isn't the Solution for Energy," *Roll Call* (July 13, 2011) (available at http://www.rollcall.com/issues/57_6/NAT_GAS_act_isnt_solution_energy-207234-1.html). AAR agrees with Mr. Dooley that uncertainty caused by regulatory intervention which distorts markets will chill investment in an industry, be it chemicals or railroads.

rather than the increased exercise of market power."[2] Widespread evidence of strong growth in demand for rail service, increasing levels of traffic and tightening rail capacity provides further explanation for increasing rail rate levels, as do other factors such as the changing competitive landscape in the trucking industry. The shippers failed to acknowledge these causal factors – and none would be addressed by changes in Board access policy – they simply want the rates to go down.

In any event, shippers have been complaining about rail rates for years regardless of whether rates are increasing or declining. The pleas for rate relief via access remedies in this proceeding are not materially different from those raised during the 1990s in the bottleneck proceedings and Ex Parte No. 575 at a time when rates were decreasing.[3] The National Industrial Transportation League ("NITL") acknowledged as much in the opening round of comments in this proceeding when it said: "The exact complaints of shippers in 1998 continue to exist in 2011 . . . ."[4]

Pursuing lower rates through mandatory access is not a permissible approach for the Board to follow and would have far-reaching adverse consequences.[5] It is the wrong approach

[2] LAURITS R. CHRISTENSEN ASSOC., INC., A STUDY OF COMPETITION IN THE U.S. FREIGHT RAILROAD INDUS. & ANALYSIS OF PROPOSALS THAT MIGHT ENHANCE COMPETITION: REVISED FINAL REPORT ES-5 (2009).

[3] *See Central Power & Light Co. v. S. Pac. Transp. Co.*, 1 S.T.B. 1059 (1996) ("*Bottleneck I*"), *clarified*, *Central Power & Light Co. v. S. Pac. Transp. Co.*, 2 S.T.B. 235 (1997) ("*Bottleneck II*"), *aff'd sub nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir. 1999); *Review of Rail Access and Competition Issues*, Ex Parte No. 575.

[4] Comments of the National Industrial Transportation League, at 10 (filed Apr. 12, 2011).

[5] Such is the case with the proposal set out in NITL's Petition for Rulemaking to Adopt Revised Competitive Switching Rules, filed July 7, 2011 in STB Ex Parte No. 711. AAR will address the defects of that proposal more fully in its reply to NITL's Petition.

because rate relief and competitive access are properly understood to be two separate things.[6] It is the wrong approach because the shipper objectives in seeking involuntary access are contrary to the controlling principles of railroad economics that have been the foundation of railroad rate regulation and competitive access policy for more than 25 years and that are widely understood to be critical to the financial viability of the railroad industry. The shippers hope that pursuing lower rates under the rubric of competitive access will enable them to evade these economic principles.

In a nutshell, the economic principles governing rail rate regulation hold that because railroad marginal costs are less than average costs, railroads are unable to recover their full costs under a regime of marginal cost pricing.[7] Railroads must be able to price some of their services, *i.e.*, the handling of higher demand traffic, at rate levels above marginal cost in order to be able to recover total costs. The shippers hope that a regime of expanded involuntary access will lead to pervasive marginal cost pricing due to the presence of two rail carriers instead of one, thereby defeating the current differential pricing policy put in place by the Staggers Act.[8]

Shippers in this proceeding claim that they do not challenge the need for railroads to engage in differential pricing, but by pushing for involuntary access that would eliminate the ability of railroads to set prices that reflect shipper demand they are doing just that. The complaining shippers target those situations where railroads can charge higher prices to shippers with less elastic demand and seek, without any determination that the rates being charged are

[6] *Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1505 (D.C. Cir. 1988) ("*Midtec*") (competitive access not "intended to be an alternative means of obtaining rate relief").

[7] This distinguishes railroads from the telecommunications industry where, as Professor Willig explained, it was determined that demand-based pricing was not necessary to cover the full costs of discrete elements of the local exchange telecommunications network. AAR Reply Comments, Reply Verified Statement of Robert Willig, at 20.

[8] Staggers Rail Act of 1980, Pub. L. 96-448, 94 Stat. 1895 (1980) ("Staggers Act").

unreasonable, to force those rates down by compelling rail-to-rail competition where it would not otherwise exist. This assault on demand-based pricing is not permissible and would place the industry in an unsustainable posture. The statute itself recognizes that rates are to be established by "competition *and the demand for services*." 49 U.S.C. § 10101(1) (emphasis added). If the shippers could force rates down below the levels that shipper demand calls for, that would preclude full cost recovery and leave railroads without sufficient revenues to replace existing infrastructure or to invest in additional capacity.

Pursuing rate relief through involuntary access would not only prevent railroads from recovering their full costs, it would imperil productivity and service on the rail network. The Board has the obligation to recognize these adverse revenue, productivity, and service impacts and avoid any measures that would threaten existing service levels and investment in the national rail network required to meet the enormous projected demand for freight rail service.

B. What Alternative Approaches Could Address Shipper Concerns?

The shippers' focus on rates at the June 22-23 hearing was further reflected in their many complaints about the process of pursuing rate relief at the Board, including complaints about the cost of pursuing rate relief and about the limits on relief available under the Three Benchmark and Simplified SAC rate standards. While these issues do not fall within the intended scope of this proceeding, they could be raised in other proceedings before the Board. The Board has demonstrated a willingness to simplify and expedite the process of pursuing rate relief before the agency. At the June 22-23 hearing, former Board Director of the Office of Proceedings David Konschnik identified in his testimony an impressive list of Board initiatives and accomplishments regarding access to rate relief.[9] The Board only recently reduced filing fees. If

[9] *See also* AAR Initial Comments, at 14.

the underlying problem is rate regulation, the focus should lie there, not on indirect approaches to rate regulation that would damage rail service and investment.

II. SPECIFIC QUESTIONS RAISED AT THE HEARING

A. Should a Pilot Program for Reciprocal Switching Be Pursued?

The possibility of a "pilot program" involving reciprocal switching was raised at the June 22-23 hearing, but the contours of such a potential program remain unknown. Presumably, the idea behind such a program would be to obtain further data on whether expanded involuntary reciprocal switching might be a feasible and acceptable access option. While it is difficult to respond in the abstract to the concept of a pilot program, there are multiple reasons to believe that such a program would be both counterproductive and unlawful.

The Board could not adopt a pilot program without first confronting and resolving the many difficult questions that would arise with expanded involuntary switching. In particular, the Board could not implement a pilot program without first adopting access pricing standards and procedures that would necessarily be an integral part of any pilot program. This would be a labor intensive and time consuming task. As Professor Willig pointed out in his June 22 testimony, developing compensation standards for access in the telecommunications industry took more than a decade and involved multiple rounds of agency rulemakings and appellate litigation. Establishing access pricing standards and procedures would be only one aspect of determining how, when, and where reciprocal switching would be imposed under a pilot program.

Nor could the Board impose on a limited basis an involuntary access regime that it does not have statutory authority to impose in the first place. As AAR indicated in its comments and testimony, the courts have made absolutely clear that the STB lacks statutory authority to use reciprocal switching to restructure the industry.[10] Thus, the STB would not be free to use reciprocal switching to restructure the industry for a limited time period, in a particular geographic location, or in some other limited manner, under the rubric of a pilot program.

Even if the Board had the statutory power to adopt a pilot program, the potential negative consequences of a pilot program are clear from the evidence already submitted in this proceeding. First, the railroads provided detailed comments, testimony, and verified statements concerning the adverse operational consequences of mandated reciprocal switching.[11] As the railroad witnesses indicated, allowing shippers to interfere with routine rail operations by introducing additional switching operations would have a highly disruptive impact on railroad operations. Depending on where reciprocal switching takes place, the result of introducing a pilot program could be widespread inefficiency and service declines in the railroad network, possibly including a service melt-down if affected terminal areas become gridlocked. As the Board knows from prior experience, gridlock on one part of the rail network can easily spread to other parts of the network and can be very difficult to resolve once it has begun.

Second, the consequences of a hypothetical pilot program on rail capital investment would be difficult to determine. Investments that should be made by the incumbent railroad might be deferred because the return would be too uncertain during the pendency of the pilot program. Railroads not directly affected by a pilot program might also be unwilling to make capital investments necessary to provide efficient service given the uncertainty over the continuation of the pilot program or the scope of any future mandated switching. Thus, a pilot

[10] *See, e.g.*, AAR Initial Comments, at 26-31; AAR Reply Comments, at 32-34; *Baltimore Gas & Electric v. United States*, 817 F.2d 108, 114-15 (D.C. Cir. 1987); *Midtec*, 857 F.2d 1487, 1505-07.

[11] *See, e.g.*, Opening Comments of Norfolk Southern Railway Company, Verified Statement of Mark D. Manion (filed Apr. 12, 2011); Comments of Union Pacific Railroad Company, Verified Statement of Lance M. Fritz (filed Apr. 12, 2011).

program may not shed any light on how or to what extent a permanent mandated switching regime would affect rail investment. Moreover, there was testimony at the June 22-23 hearing that a pilot program would increase investor uncertainty about the direction of future regulation in the rail industry.

Third, any pilot program would almost surely have a disproportionate impact on some railroads as opposed to others, depending upon its parameters. The Board would be placed in the position of deciding which railroads should be subjected to the direct harms of an involuntary access pilot program and which railroads would suffer the less direct (but no doubt substantial) harm from the program's impact on the efficiency and operation of the national rail transportation network. Picking winners and losers among railroads is not an appropriate component of regulatory oversight.

Fourth, it is far from clear that a pilot program could be designed in a manner that would produce meaningful results. Evaluating the results of a pilot program would be a highly uncertain endeavor. Establishing a baseline against which the experimental results could be compared would be difficult. For example, different geographical areas in which reciprocal switching could occur have different network and traffic characteristics and the "results" in one area would not likely be an accurate indicator of the "results" that could be expected in another area. Nor is it clear what criteria could be used to measure the "success" of a pilot program, and the need for sound, transparent criteria cannot be overstated. For example, if the pilot program reduced rates enough to impair investment in the rail network if applied nationally, would shippers claim a "success" when in fact that would foretell disaster?

Whatever the criteria might be, the Board should expect some shippers, as some did at the hearing, to assert that any pilot program would be subject to manipulation by the railroads and would not be allowed to work. This claim could be expected even if the pilot program failed for any of the reasons that AAR and its member railroads have indicated would lead to such a result.

Given the numerous pitfalls presented by a potential pilot program, AAR believes that it would be entirely counterproductive for the Board to pursue this idea further. The Board would be pursuing a project that could have a widespread negative impact on railroads and shippers alike, and that would likely cause lasting harm from which it could take years to recover.

B. What Are the Rail Revenue Impacts of Expanded Access Based upon an RSAM "Trigger"?

In his written comments and in his testimony at the June 22 hearing, AAR's witness William Rennicke discussed the potential revenue losses for the railroads that would result from expanding involuntary access remedies. Mr. Rennicke showed that if an expansion of involuntary access drove rates down to the jurisdictional threshold of 180 percent of variable costs, the railroad industry could lose $5.2 billion annually in revenue, substantially reducing the capital that would be available to fund necessary infrastructure expansion in the future.[12]

In a question posed to the AAR panel at the hearing on June 22, Chairman Elliott noted that the Concerned Captive Coal Shippers ("CCCS") had proposed, among other things, a "trigger" mechanism that would give shippers the right to an access remedy only if the shipper's rate exceeded the railroad's RSAM level. Chairman Elliott asked the AAR panel whether AAR had determined the revenue impact of such a "trigger" based proposal, setting aside the question whether such a trigger would be legal.

Although it would be possible to calculate the extent of railroad revenue losses if rates were effectively capped at a given R/VC level, doing so would not reflect the actual revenue

[12] *See* AAR Initial Comments, Verified Statement of William J. Rennicke, at 19.

losses that could be expected under a regulatory program using a trigger like those suggested by CCCS and NITL.[13] While using a "trigger" mechanism would limit the availability of access remedies to shippers whose rates exceed a particular R/VC level, such as the railroad's RSAM level, the trigger mechanism would not limit the extent to which rates decrease as a result of mandated access. Post-access rates could be well below the trigger level and even below 180% of variable costs. A simple example involving reciprocal switching demonstrates the point.

Assume a through movement that generates revenues above the railroad's RSAM level. An involuntary access order could require the incumbent railroad to switch the movement to another railroad at a point close to the origin if the shipper chose to use the other railroad from the switching point to the destination. The ensuing competition between the two railroads for the segment of the movement from the switching point to the destination could drive rates for that segment significantly below 180% of variable costs. Regardless of who wins that competition, the contribution available under the old rates to offset the fixed costs to provide service from the switching point to the destination would be substantially reduced. As to the remaining portion of the movement from the origin to the switching point, the shippers propose that the originating railroad would only receive as compensation its cost of providing the switching service. Thus, as a result of involuntary access, through rates originally set at a level above the incumbent railroad's RSAM could be driven down to a level potentially far below 180% of the variable cost of the through movement.

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[13] The CCCS comments proposed an RSAM "trigger" as well as an average R/VC above 180 percent "trigger." NITL's Petition for Rulemaking proposes a similar R/VC-based "trigger" mechanism. Any R/VC-based "trigger" set at a level that would impose access for a material volume of traffic should be expected to result in substantial revenue losses on the traffic subject to involuntary access.

Even if a trigger mechanism limited the availability of an access remedy to a subset of shippers, the reduction in revenues generated on the movements subject to involuntary access could be very substantial. Indeed, rates on the movements subject to involuntary access could easily be driven below 180% of variable costs.

C. Are there Any Academic Analyses of Railroad Revenue Adequacy?

Commissioner Mulvey inquired about the existence of recent objective, academic studies on railroad profitability and revenue adequacy. Commissioner Mulvey was responding to the comments of several shippers to the effect that the Board should not be concerned about revenue losses to railroads that would result from expanded access because the railroads have become highly profitable entities that can afford to transfer some revenues to their shippers.

The current revenue adequacy standards, adopted in the early 1980s, were based on extensive economic analysis by ICC staff and by economists that participated in the proceedings that led to the adoption of the current revenue adequacy standards. Since then, the ICC and the Board have not undertaken a comprehensive review of the economic theory underlying the current standards, and AAR is not aware of any significant independent academic analysis of railroad revenue adequacy or the economics underlying revenue adequacy standards.

In 1998, the Board proposed to undertake a review of the economic principles that should inform the Board's determination of railroad revenue adequacy. In the Board's review of rail access and competition issues in Ex Parte No. 575, shippers argued, as they argue here, that the results of the Board's revenue adequacy assessments are not consistent with other economic measures of profitability and overstate railroads' financial needs. The Board responded by proposing that the railroads and shippers convene a panel of expert economists to review the economic theory relevant to the revenue adequacy question and to recommend whether the existing standards should be retained or changed. The shippers declined to participate, claiming that such a procedure would be too "elaborate and expensive." *See Review of Rail Access and Competition Issues*, Ex Parte No. 575 (served May 4, 1998).

As AAR stated in its written comments in this proceeding, AAR strongly believes that the correct measure of revenue adequacy is that a railroad should be able to earn its cost of capital on a properly defined asset base, which AAR believes should be based on replacement cost.[14] The railroad industry remains willing to participate in a serious review by independent economists of the economic and financial principles that should govern determination of railroad revenue adequacy.

D. Are there Alternative Standards that Can Be Used to Determine Whether Competitive Access Should Be Granted?

Many shippers stated at the June 22-23 hearing that they are seeking only modest or incremental changes in the existing access rules. Through their diverse proposals, however, shipper groups called for every form of comprehensive regulation from rate caps to bottleneck rate changes to reciprocal switching. Moreover, shippers were unable or unwilling to state what alternative standards could be adopted that would result in such incremental change.

As AAR explained, anticompetitive conduct should be a predicate for any grant of access.[15] Access remedies are not intended to be used to restructure the railroad industry or to be

[14] *See* AAR Initial Comments at 17; *see also* AAR Reply Comments, Verified Statement of Robert S. Hamada & Rajiv B. Gokhale at 9. An investment analyst who testified at the hearing agrees. *See* testimony of Scott Group, Wolfe Trahan & Co., video transcript at 2:40 (afternoon June 22, 2011).

[15] Shipper calls for greater rail-to-rail access premised on purported changes in the structure of the rail industry, including increased consolidation, are misplaced. Such arguments consistently and conveniently disregard that the Board addressed such concerns in its review of the most recent rail mergers and that, pursuant to Board policy, no shipper that had competitive rail options prior to a consolidation is without a competitive rail option afterwards. Moreover, every consolidation that the Board has considered and approved in this era has been accompanied by findings that the transactions would produce significant public benefits in terms

an unlawful, uneconomic substitute for sound rate regulation but to address specific instances of railroad conduct. Yet the shippers have not proposed any conduct-based standard for competitive access as an alternative to the existing standards. Grants of involuntary access without reference to an underlying conduct-based standard to determine whether access would be appropriate would amount to access on demand. As AAR explained in its comments and testimony, the existing statute does not permit a regime of access on demand.

Some advocates of involuntary access maintain that setting rates at or above a certain R/VC level should be viewed as "anticompetitive conduct" and that a standard based on rate levels is therefore "conduct-based." This argument is a clear attempt to obfuscate the distinction between rate relief and mandated access. The Board has procedures in place to determine whether rates are unreasonable and therefore contrary to the statute. As the court made clear in *Midtec*, the standard for granting access remedies must be something other than "rates are too high" to avoid running afoul of the statutory scheme. *Midtec*, 857 F.2d 1487, 1505-07. A rate-level standard for granting access is simply an attempt to evade the statutory requirements that pertain to rate-reasonableness regulation.

Counsel for NITL told the Board at the hearing that NITL was working on a "middle ground" proposal. That proposal, which has now been submitted in a separate docket, does not contain a conduct-based standard as an alternative to the current competitive access rules. As AAR will explain in its response to NITL's petition, the supposed "middle ground" proposal relies on categorical presumptions that would entitle shippers served by a single railroad to access to a second rail carrier without any conduct-based showing. This would result in a restructuring of the rail industry that is not permissible under the current statutory scheme.

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of reduced costs, greater efficiencies, and improved rail service, all of which have been borne out in the years since.

CONCLUSION

In this proceeding, the shippers have presented no evidence of changed circumstances that would justify new competitive access rules and have proposed no rules that would pass muster under the existing statute. And, while the complaining shippers choose not to address the public interest side of the equation, the record is clear that the public interest calls for increased investment of private capital in the rail infrastructure and for railroads to continue to operate an efficient national rail network. That will not happen if railroad revenues are diverted to shippers or lost through inefficiency due to involuntary access.

Respectfully submitted,

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